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IN THE

Supreme Court of the United States

OCTOBER TERM, 1956.

No. 316.

CHARLES B. SMITH, as Special Administrator of the Estate of Edward S. Birn, Deceased,

Petitioner,

vs.

MILTON SPERLING, HARRY M. WARNER, JACK L. WARNER, UNITED STATES PICTURES, INC. and WARNER BROS. PICTURES, INC.,

Respondents.

Brief of Respondents Warner Bros. Pictures, Inc., Jack L. Warner and Harry M. Warner in Opposition to Writ of Certiorari.

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Brief of Respondents Warner Bros. Pictures, Inc., Jack L. Warner and Harry M. Warner in Opposition to Writ of Certiorari.

The petitioner asks review of a decision of the Court of Appeals (Ninth Circuit) affirming a judgment of dismissal by the District Court rendered as to one count of a shareholder's derivative suit in which federal jurisdiction depended upon diversity of citizenship. By order of the District Court, the question of jurisdiction had been tried as a separate and preliminary issue. The trial thereon resulted in findings of fact made by the District Court which were reviewed by the Court of Appeals and found to be adequately supported by the evidence. Pursuant to the facts so found, the District Court determined that

Warner Bros. Pictures, Inc., the corporation on behalf of which the action was brought, though named in the complaint as a defendant, should, for the purposes of determining jurisdiction, be realigned as a plaintiff and that upon such realignment diversity no longer existed and hence there was no federal jurisdiction. The Court of Appeals reversed and remanded the case to the court below for further proceedings as to the second cause of action, which had been dismissed for lack of equity, and this does not appear to be herein involved.

The Question Presented.

We believe the case presents only one question and that is:

1. When facts are found after a trial, lasting more than fifteen days, which negate the corresponding allegations in the complaint, and which establish that the acts of the corporation were in good faith, without fraud, with no control or domination of its Board of Directors, or wrongful participation by any director, or officer, and that the corporation was not in the hands of anyone antagonistic to its interests, should the realignment of Warner Bros. Pictures, Inc. as a plaintiff, by the Trial Court be disturbed?

Statement of the Case.

The opinion of the Court of Appeals herein sets forth verbatim the findings of the District Court relating to the first cause of action [Pet. App. B, pp. 2-5; R. pp. 73-77]. The Court of Appeals examined the record and was satisfied that the findings were adequately supported. This is not a case, therefore, in which the allegations of a pleading must be accepted at face value but is one in which the realities of the controversy have been deter-

mined upon a lengthy trial, and full consideration of evidence reflected in a reporter's transcript nearly 2000 pages in length.

The complaint named Warner Bros. Pictures, Inc. as a defendant. It complains of the making of a motion picture production contract. It alleges that the plaintiff was the owner of 400 shares of stock from a time prior to the making of that contract [R. p. 4]; that the action was not collusive in order to confer jurisdiction [R. p. 3]; that demand upon the directors of the corporation to institute the action had not been made, but would be futile because all or a majority of the Board of Directors wrongfully participated in the acts complained of and because the Board was controlled by the active wrongdoers [Par. 24, R. p. 11]. These allegations together, that is to say Paragraphs 1, 4 and 24 of the complaint are obviously designed for the purpose of procedural compliance with Rule 23(b) (App. I) of the Rules of Civil Procedure (formerly Equity Rule 94).

Distinct from these assertions by way of formal compliance with the Rule, and to set forth the asserted grievance, the complaint alleges the making of a contract in 1945 between Warner Bros. Pictures, Inc. (Warner) and United States Pictures, Inc. (United) for the production of a substantial number of motion pictures over a number of years, such pictures to be made by United with partial or complete financing by Warner [Pars. 12 to 22 incl., R. pp. 5-10 incl.]. It alleges a conspiracy among the individual defendants to waste and divert the funds of Warner and enrich United and Sperling [Par. 11, R. p. 5] through the making of such contract and that the individual brothers Warner together owned a controlling block of the stock of Warner and controlled

and dominated the corporation, actively directed its policies and actions, including the acts complained of and did actually select, dominate and control the directors and officers of the corporation.

In contrast to such allegations, the facts as found after trial were that Warner was the real party in interest in the claim made [F. III, App. B, pp. 2-3]; that the Warner-United contract was made in good faith, without fraud, was considered by the Board of Directors to be a sound business arrangement for the best present and future interests of the corporation and intended to be a financial benefit to it; that the officers and Board of Warner acted in good faith and exercised their independent business judgment; that the Board of Warner consisted of eleven men, including the two individual brothers Warner named as defendant and a third brother not named as a defendant, all of whom together owned less than 20% of the outstanding stock; that neither the corporation nor the directors or officers were then or at any time under the domination or control of the brothers Warner, and that neither the stockholders, officers or directors were at any time antagonistic to the financial interests of the corporation [F. IV, App. B, pp. 3-4]. It was found that it was not true that any of the Board or officers of Warner wrongfully participated in the acts complained of and that if demand had been made upon the corporation to institute this action, the persons to whom such application would be made would not have been disqualified from faithfully doing their duties because of any matters set forth in the complaint or otherwise. It was found that the stockholders were not at any time or at all under the domination or control of the brothers Warner.

Summary of Argument in Opposition to Issuance of Writ.

1. The facts show the making of a contract by a corporation through its Board of Directors, eleven in number, which was in its line of business and regarded by the Board as a sound business arrangement; which was so made in the free and independent exercise of its duties and rights by such Board in good faith and without fraud; with no element of conspiracy, wrongdoing, control or domination by the individual defendants; with no invalidity by reason of statute or by-law or other claim of *ultra vires;* and with no control of the corporation antagonistic to its financial interests. Under these facts, the realities determined after trial required realignment of Warner for jurisdictional purposes as a plaintiff, after which diversity did not exist.

2. The question of jurisdiction and the question of compliance with Rule 23(a) are separate and distinct matters and whether or not the requirements of the Rule may be jurisdictional is not here involved. The decisions of this court cited in the argument deal with jurisdiction as such and not merely with procedure under rule, and where such decisions have resulted in a refusal to realign a corporate party for jurisdictional purposes, they have done so on the basis of allegations in the pleadings concerned or on the basis of facts found to be true showing the presence of fraud, control and domination, completely absent in the case at bar.

3. There is no conflict with the cited decisions of the Second or Seventh Circuits, and a very recent decision in the Seventh Circuit is in complete harmony.

4. The present decision of the Court of Appeals will not bar all future derivative suits from the federal courts,

but is a decision based upon facts found after trial on adequate evidence and the ruling thereon would not affect other cases in any way unless such other cases were based upon substantially equivalent facts.

Argument.

A.

The petition herein presents two questions (Pet. pp. 2-3), the first of which appears virtually moot since it is based on assertions of fact without consideration of the findings of the Trial Court on the issues covered thereby, and the second appears to question the power of a federal court to make realignment of a party with the consequent destruction of diversity. The power of a federal court to realign the parties for jurisdictional purposes is, we submit, beyond question and it is, in fact, the duty of the court to consider and determine their arrangement for such purposes.

Indianapolis v. Chase National Bank, 314 U. S. 63 at page 69.

B.

1. The petition here (p. 6) asserts that the present judgment is not supported by certain decisions of this court, but is in conflict with them, in that allegations or proven facts relating to domination and control do not relate to jurisdiction as such, but only to procedural compliance or non-compliance with former Equity Rule 94 (now Rule 23(b) of Rules of Civil Procedure). In the present case, petitioner, [Complaint, Par. 24, R. p. 11] and obviously because of the requirement of Rule 23(b), stated that no demand had been made upon the directors of the corporation and alleged as his reasons for not making such demand, applicable only to excuse

such failure, that at least a majority of the Board of Directors had wrongfully participated in the acts complained of and that the Board was controlled by the alleged miscreants. Irrespective of contrary findings, an allegation of reasons in the *complaint* is required by the Rule. However, in the body of the complaint, as already pointed out, and as a basis for the claim that the contract involved was wrongful and not merely to excuse demand, the complaint asserted conspiracy, control and domination of the corporation and its Board of Directors by the individuals. All of these allegations were completely negatived by the findings. Petitioner, we believe, confuses these elements in his own case and endeavors to interpret the decisions of this court accordingly.

Venner v. Great Northern Railway Co., 209 U. S. 24, makes clear the distinction and, following only three years after the decision in *Doctor v. Harrington*, 196 U. S. 579, is of value in analysis of the latter. In both, the question of jurisdiction was certified to this court. In the *Venner* case there were two elements, (1) jurisdiction as dependent upon diversity and (2) jurisdiction of the subject matter by reason of non-compliance with Equity Rule 94. The facts involved were those set forth in the complaint and not facts determined after proof. The allegations were that the Railway Company was under the absolute control and domination of the late James J. Hill and while in such position and exercising such control, he sold securities to it at a vast profit to himself. The complaint failed to comply with Rule 94 in that it did not allege the plaintiff to have been a stockholder at the critical times, *i. e.* the assertions of fraudulent domination and control were not a factor in the second question. This court said that alignment of parties in the position where their interest in and attitude

to the controversy should really place them, would still leave such parties as arranged by the pleader, because Hill and the corporation were alleged to have engaged in the same illegal and fraudulent conduct and the injury was brought about by their joint action, even though it might be for the financial interests of the corporation that the plaintiff should prevail. On this issue and not in connection with consideration of the effect of Rule 94, this court cites *Doctor v. Harrington* as precisely in point and, speaking of jurisdiction as such, notes that in the *Doctor* case, Harrington had directed the management of the affairs of the corporation, dictated the policy and selected the directors and that Harrington had fraudulently caused the corporation to act. This view of the *Doctor* case is that of this court and is the best comment thereon. In *Doctor v. Harrington* there was substantive compliance with the Rule and the question of formal compliance was not at issue, the single question certified to this court being a matter of jurisdiction based upon diversity.

Central Railroad of New Jersey v. Mills, 113 U. S. 249, and *Railroad v. Grayson,* 119 U. S. 240, are cited and discussed by petitioner, but neither touches the issue here. In each of those cases, the grievance alleged was an *ultra vires* act of the corporation, thereby giving rise to a real complaint by a stockholder against his own corporation. These two decisions differ basically from those cases involving a transaction in which the alleged vice is that it occurred while, and because, the corporation was under a disability due to improper domination by certain individuals.

In *Delaware & Hudson Co. v. Albany & Susquehanna Railroad Co.,* 213 U. S. 435, cited in the petition but not

by the Court of Appeals herein, the question certified to this court was whether failure to conform to Rule 94 prevented plaintiff from maintaining the suit. The opinion points out that in the *Doctor* case, there had not been formal, but had been practical compliance with the Rule in that the general facts alleged showed that it would have been futile to appeal to the Board for action. The matter was not one of realignment and *Doctor* showed that practical compliance with the Rule would permit maintenance of the suit.

Indianapolis v. Chase National Bank, 314 U. S. 63, would not ordinarily be described as a derivative suit though brought by a trustee on behalf of bond holders. It demonstrates that realignment may and should be made by the Federal Court whenever required, and that the power is not restricted to derivative suits by shareholders.

The very nature of a shareholder's derivative suit, as discussed in *Hawes v. Oakland*, 104 U. S. 50, brought about the formulation of Rule 94 and its successor Rule 23(b) requiring allegations to show that the nominal plaintiff was a proper person to set in motion the machinery of the court. A corporation is an entity which the complaining stockholder must show to be under some disability requiring that stockholder, as a self-appointed "next friend" or guardian, to bring suit on its behalf and for its benefit. This court has so described the relationship in *Koster v. American Lumbermens Mutual Casualty Co.*, 330 U. S. 518 at 522-523; and in *Illinois Central Railroad v. Adams*, 180 U. S. 28 at 34.

The disability asserted in such cases is usually, as here, that the corporation is so completely dominated by the individuals alleged to be miscreants that the corporation has no will of its own, but is practically the *alter ego* of

such miscreants. The *Venner* and *Doctor* cases, as well as *Cutting v. Woodward*, 255 Fed. 633, are examples of such disability attributed by allegation or proof to fraudulent domination and control. In the case at bar, these essentials were alleged, but at the trial they were proved untrue and the findings are to the contrary. The fiction must give way to the fact.

C.

Petitioner asserts that the decision here is in conflict with *J. R. A. Corporation v. Boylan*, 30 Fed. Supp. 393 (affirmed 109 F. 2d 1018), and *Lavin v. Lavin*, 182 F. 2d 870 in the 2nd Circuit and *Schmidt v. Esquire*, 210 F. 2d 908 in the 7th Circuit. The asserted conflict does not exist.

In contrast to the decisions cited in the petition, a very recent case in the 7th Circuit, *Swanson v. Traer*, 230 F. 2d 228, shows the complete harmony of that Circuit with the case at bar. The opinion therein cites and quotes from the opinion of the District Court herein, and reviews the same precedents as are herein involved. The Court of Appeals there affirmed a realignment of the corporation with resulting destruction of diversity. It does not cite or discuss *Schmidt v. Esquire* from its own Circuit, and this indicates, we submit, that the *Schmidt* case is not authority in the areas herein concerned, for the reasons hereinafter demonstrated. Furthermore, the opinion distinctly holds that a refusal by the Board of Directors to take action does not show antagonism, but merely a difference of opinion between the plaintiff and his corporation as to the wisdom of such action. It says that the test is whether there is a collision between the personal interests of those in control of the corporation (here the Board of Directors) and the interests of the corporation

in the subject matter of the suit. In the case at bar, the findings show there was no such collision as to require the retention of the corporation among the named defendants.

In the case at bar, the District Court expressed precisely the same thought and said (Pet. App. B, p. 46):

> "Patently, if difference of opinion were all the 'controversy' required to be shown between the stockholder and his corporation in order to preclude alignment of the latter with the plaintiff-stockholder, then there can be no occasion for all the pages of discussion of corporate domination or control, since every stockholder's derivative suit is by definition predicated upon the assumption that the corporation has refused to sue."

Schmidt v. Esquire, 210 F. 2d 908 (actually three cases) was a libel suit by a stockholder of the ill-fated Tucker Corporation against a number of publishers. In one suit, motion to remand had been made and denied because the court would not realign the Tucker Corporation as a plaintiff. On appeal, the 7th Circuit noted that it had not been the practice to realign such a corporation as a plaintiff merely because the action was one to enforce a corporate claim and recovery would be for the benefit of the corporation, but that the corporation would be left a defendant on the theory that it was controlled by antagonistic hands. This would seem to mean that there would be no realignment in such a case unless the *theory* of antagonistic control was overcome by the facts. The court remarks that a different rule of alignment would not be applied when there was no indication that the corporate management had refused to take action from fraudulent or other improper motives. These com-

ments of the court are actually dictum because it concluded that the citizenship of the Tucker Corporation was immaterial in any case, since it was in bankruptcy and a suit had not been authorized by the proper court. Even so, the dictum is correct in that it is not the refusal to take action on the part of the corporation or the reasons for that refusal which are relevant to realignment. The rule of alignment mentioned by the court is that established by *Koster, Venner* and *Doctor*.

In *J. R. A. Corporation v. Boylan*, 30 Fed. Supp. 393, the plaintiff corporation (New York), a stockholder in a New Jersey corporation, brought suit as such against the corporation and a number of its directors for waste. Many of the individual defendants were citizens of New York. In claiming diversity, the plaintiff apparently argued that under the state laws of New York the corporation and not the plaintiff was the *only* real plaintiff, and that, therefore, the citizenship of the actual plaintiff should be disregarded. If this were done, the New Jersey corporation would be the only party plaintiff, resulting in diversity between the New Jersey corporation and the individual directors, who were citizens of New York. The court said that it did not so interpret the rulings of the state courts of New York. Complete disregard of the citizenship of the actual party plaintiff would seem to be a unique idea, and unless this were done, realignment of the corporate defendant as a plaintiff would not have changed the situation so far as diversity is concerned. Clearly, the dismissal for lack of jurisdiction was correct. There was nothing parallel to the present case in any way and the mention of the *Doctor* and *Venner* cases in the decision itself does not assist this court in its analysis of its own decisions.

Lavin v. Lavin, 182 F. 2d 870, is again relevant only insofar as the court there comments on the *Doctor* case and indicates its view that the preferable rule would be that the corporate defendant should be automatically aligned as a plaintiff irrespective of assertions of domination or control if *Doctor* had not established an exception where there was antagonistic control, a view consonant with that of the Seventh Circuit in *Swanson v. Traer, supra,* where that court said realignment would be made unless the plaintiff could show facts to support allegations that the corporation was in antagonistic hands.

D.

Petitioner particularly claims error here in view of this court's decision in *Indianapolis v. Chase National Bank,* 314 U. S. 63. This case has already been mentioned and, of course it was not a shareholder's action. It does confirm the right and duty of a federal court to arrange the parties as they should be under the realities for the purpose of testing jurisdiction. In that case the true controversy was as to whether the assignee of a lease would be bound by its terms, and the asserted wrong lay in the refusal of the assignee to be so bound. The dispute, therefore, was between a lessor and an assignee of a lease on a question of law. This court ordered realignment with consequent failure of jurisdiction, because the actual plaintiff, a bondholder, and the lessor corporation were actually on the same side of the controversy. In the present case, absent all claim of fraud, lack of good faith or other misconduct or domination or control of Warner and absent all claim of *ultra vires* on the part of Warner under charter, by-laws or any statute, there is no controversy between the plaintiff and his corporation, as distinct from a controversy between the plaintiff and Warner on one side

and United on the other and realignment was required as in the *Indianapolis* case. The *Indianapolis* case, not being a shareholder's suit, was not subject to the requirements of Rule 23(b), which shows that the Rule has nothing to do with alignment, and by the same token, the position of the plaintiff therein did not involve the relationship of a shareholder to his own corporation.

E.

Petitioner, as his last point in requesting the issuance of a writ herein, urges that the matter is one of great importance in that if the present decision is allowed to stand, it will bar the federal courts to practically all derivative suits. The present case involves a specific application of rules many times considered by this court and other courts of appeal and does not present any new questions of principle. It is specificially based upon findings of fact set forth in full in the decision and could be a precedent only to the extent that those facts are substantially duplicated in some other action. As noted by the Court of Appeals herein, the petitioner cannot complain of a divergence of fact between his case and some other case in a different court; nor would any other plaintiff be affected if a divergence should exist. We submit it is improbable that any plaintiff in the future would *allege* facts duplicating the present proven facts, though after proof in such other suits there might well be substantial duplication, but if so, we submit it has been demonstrated herein the results should be the same, not necessarily on the basis of the present decision as a prece-

dent, but on the basis of a long line of decisions on the subject which are applied and reflected herein.

The opinion of the Court of Appeals herein suggests that there may be no reported precedent for the action of the Trial Court here in holding a trial of the facts relating to jurisdiction, separately and in advance of a full trial on the merits. (Pet. App. B, p. 8.) We submit no question arises because of such trial, since Rule 42(b), (App. II), cited by the court (Pet. App. B, p. 7), clearly permits isolation and separate trial of any issue, and the application of the Rule here was in the exercise of the soundest discretion, and in the best interests of the court and of all parties. The determination of the relevant facts on the trial, directly contrary to the corresponding allegations, is the factor requiring a result differing from the result in *Doctor* and *Venner*, for example, where the allegations alone were before the court, though the applicable rule is the same.

Conclusion.

The Court of Appeals epitomizes the general situation here in saying (Pet. App. B, p. 8):

> "It would be burdensome to the court and litigants if everyone were forced to accept allegations which all knew were false as a basis for jurisdiction and proceed to a long and expensive trial of the case, only to find by this arduous process that the allegations were untrue. Allegations are extremely easy to write. The tendency to abuse of stockholders derivative actions is too well known to require com-

ment. Once the facts are found, as here, proper realignment must be made and jurisdiction does not exist."

It is respectfully submitted that no showing has been made by the petitioner herein which would require the issuance of a writ.

Respectfully submitted,

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APPENDIX I.

Rule 23(b), Rules of Civil Procedure.

"In an action brought to enforce a secondary right on the part of one or more shareholders in an association, incorporated or unincorporated, because the association refused to enforce rights which may properly be asserted by it, the complaint shall be verified by oath and shall aver (1) that the plaintiff was a shareholder at the time of the transaction of which he complains or that his share thereafter devolved on him by operation of law and (2) that the action is not a collusive one to confer on a court of the United States jurisdiction of any action of which it would not otherwise have jurisdiction. The complaint shall also set forth with particularly the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort."

APPENDIX II.

Rule 42(b), Rules of Civil Procedure.

"The court in furtherance of convenience or to avoid prejudice may order a separate trial of any claim, cross-claim, counterclaim, or third-party claim, or of any separate issue or of any number of claims, cross-claims, counterclaim, third-party claims, or issues."